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No. 92-994

In the Supreme Court of the United States

OCTOBER TERM, 1992

JOHN H. WHITEHOUSE AND
CAROL A. WHITEHOUSE, PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

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QUESTION PRESENTED

Whether the entity known as "Water Resource Control" was (i) a "grantor trust," the income of which would be taxable to petitioners under Section 671 of the Internal Revenue Code, 26 U.S.C. 671, or (ii) an "association," the income of which would be taxable as a corporation under Section 7701 of the Code, 26 U.S.C. 7701.

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OPINIONS BELOW

The opinion of the court of appeals (Pet. App. 1-3) is unpublished, but the decision is noted at 972 F.2d 1328 (Table). The memorandum opinion of the Tax Court (Pet. App. 4-103) reported at 61 T.C.M. (CCH) 2102.

JURISDICTION

The judgment of the court of appeals was entered on July 24, 1992. The petition for a writ of certiorari was filed on October 21, 1992. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

STATEMENT

1. Petitioners John H. Whitehouse and Carol A. Whitehouse are a husband and wife who filed joint income tax returns for 1979 and 1980, the tax years at issue. In October of 1978, Mr. Whitehouse and James S. Jenkins, president of the Meditator Company, purported to establish a "Pure Common Law Trust" called Water Resource Control (WRC) (Pet. App. 14-15). The purpose of WRC, as stated in the Declaration of Trust, was "to provide for the growth and preservation of the corpus" (Pet. App. 16-17). Mr. Whitehouse provided the corpus of WRC, which consisted of the rights to his invention, the Meditator water-saving toilet. Mr. Whitehouse was appointed the sole trustee and Mrs. Whitehouse was the sole holder of the certificates of beneficial interest in WRC (Pet. App. 26-27). Upon establishment of the trust, WRC assigned all domestic rights to the exploitation of the Meditator toilet to the Meditator Company for a payment of $100,000 (Pet. App. 28). A substantial part of the income WRC received in 1979 was from its investments of these proceeds in the stock market. All of the income WRC received in 1980 was from such investments. For both 1979 and 1980, WRC reported its income and expenses on Form 1041, the fiduciary return used to report the income of trusts and estates (Treas. Reg. § 1.6012-3(a)(1)). See Pet. App. 38-40, 45-46, 84.

2. The Commissioner of Internal Revenue issued a statutory notice of deficiency to petitioners. The Commissioner took the position that WRC was a "grantor trust" and that the income of the trust was therefore taxable on petitioners' joint returns, rather than on the trust returns. See 26 U.S.C. 672-677.[1]

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[1] To prevent taxpayers from shifting their income to trusts over which they retain substantial control, Sections 671-679 establish rules under which the retention by the grantor of certain spec-

Petitioners filed a petition in the Tax Court for redetermination of the deficiency. Petitioners contended (i) that, although WRC was a trust, it was not a grantor trust, and (ii) in the alternative, that WRC was an "association" taxable as a corporation under Section 7701(a)(3) of the Code.

The Tax Court rejected petitioners' contentions. Addressing petitioners' second argument first, the court noted (Pet. App. 74-75) that, for a trust to be classified as an association, the trust must have both "[a]ssociates [and] an objective to carry on business and divided [*sic*] the gains therefrom" (26 C.F.R. 301.7701-2(a)(1)). The court held that Mrs. Whitehouse, the only beneficiary of the trust, was not an "associate" because Mrs. Whitehouse (i) neither created nor contributed to the trust, (ii) could not transfer her interest in the trust without the trustee's approval and (iii) did not participate actively in the trust's creation or conduct (Pet. App. 78-82). Because WRC lacked any associates, it could not be classified as an "association" for corporate tax purposes. Instead, it was taxable as a trust (*ibid.*). Turning then to petitioners' first argument, the Tax Court held that, because Mr. Whitehouse possessed the power to dispose of the beneficial enjoyment of corpus and income, WRC was a "grantor trust" whose income and expenses were includable in determining petitioners' taxable income under Section 671 of the Code (Pet. App. 97).

3. In a per curiam, unpublished opinion, the court of appeals affirmed "substantially for the reasons stated" in the Tax Court opinion (Pet. App. 3).

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ified powers will require the grantor to pay tax on the trust's income. See generally 3 B. Bittker & L. Lokken, *Federal Taxation of Income, Estates and Gifts* ¶ 80.1 (2d ed. 1991).

ARGUMENT

The decision of the court of appeals is correct and does not conflict with any decision of this Court or of any other court of appeals. Further review is therefore not warranted.

1. Petitioners do not now dispute that, if WRC is treated as a trust, it is a "grantor trust" and its income would be attributable to petitioners under Section 671 of the Code. Petitioners claim instead that WRC was not a trust at all, but was an "association" subject to the corporate income tax under Section 7701 of the Code. As an "association," its income would not be attributable to petitioners.

Section 7701(a)(3) of the Internal Revenue Code provides that "[t]he term corporation includes associations, joint-stock companies, and insurance companies" (26 U.S.C. 7701(a)(3)). The Treasury Regulations issued under this statute set forth six relevant criteria for determining whether an organization constitutes an "association." 26 C.F.R. 301.7701-2(a)(1).[2] The two most relevant are that an "association" must have "[a]ssociates [and] an objective to carry on business and divided [*sic*] the gains therefrom." 26 C.F.R. 301.7701-2(a)(3). See *Morrissey* v. *Commissioner*, 296 U.S. 344, 356-357 (1935). As this Court stated in *Morrissey* v. *Commissioner*, 296 U.S. at 356, an "'[a]ssociation' implies associates. It implies the entering into a joint enterprise * * * for the transaction of business." "Associates" are to be distinguished from the beneficiaries of an ordinary trust in that the latter "do not ordinarily * * * plan a common effort or enter into a combination for the conduct of a business enterprise." *Id.* at 357. See also *Hecht* v. *Malley*, 265 U.S. 144 (1924).

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[2] These criteria originate in this Court's opinion in *Morrissey* v. *Commissioner*, 296 U.S. 344, 358 (1935).

Applying this Court's reasoning in *Morrissey*, the Tax Court held in *Bedell Trust* v. *Commissioner*, 86 T.C. 1207, 1221 (1986), that beneficiaries are not "associates" of a trust if (i) they have not contributed to the trust's corpus, (ii) their interests in the trust are not transferable, and (iii) they do not participate in trust affairs. See also *Solomon* v. *Commissioner*, 89 F.2d 569, 571 (5th Cir.), cert. denied, 302 U.S. 692 (1937); *Elm Street Realty Trust* v. *Commissioner*, 76 T.C. 803, 814-815 (1981); *Teich Trust No. One* v. *Commissioner*, 25 T.C. 884, 891-892 (1956); Lyons, *Comments on the New Regulations on Associations*, 16 Tax L. Rev. 441, 454-455 (1961). Applying that analysis to the facts of this case, the Tax Court correctly held that Mrs. Whitehouse was not an "associate" of WRC because (i) she did not contribute any property to WRC (Pet. App. 79-80), (ii) she did not have the power freely to transfer her beneficial interest in the trust (*id.* at 80-81), and (iii) she did not participate in the creation or affairs of WRC (*id.* at 81-82, 95-96). Mrs. Whitehouse thus did not take part in WRC as a "cooperative undertaking" (*Morrissey* v. *Commissioner*, 296 U.S. at 357) and therefore was not an "associate" of the trust. Because WRC had no "associates," it was not an association taxable as a corporation under Section 7701(a)(3).[3]

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[3] In any event, although the Tax Court did not reach this issue (see Pet. App. 83 n.21), we note that Mr. Whitehouse: (1) could have organized WRC as a corporation but chose instead to organize it as a trust; and (2) could have filed corporate returns for WRC but chose instead to file fiduciary returns (thus representing to the Commissioner that WRC was a trust). Having chosen to organize WRC as a trust, petitioners should not now be heard to complain that it was in reality a corporation. See *Commissioner* v. *National Alfalfa Dehydrating & Milling Co.*, 417 U.S. 134, 149 (1974) ("while a taxpayer is free to organize his affairs as he chooses, nevertheless, once having done so, he must accept the tax consequences of his choice, whether contemplated or not * * * and may not enjoy

2. Petitioners err in contending (Pet. 1, 14-24) that the decision in this case conflicts with *Morrissey* v. *Commissioner*. *Morrissey* was the third of a trilogy of cases addressing the circumstances under which the Commissioner may reclassify an entity as an "association," and thereby subject it to corporate income and excise taxes. See also *Crocker* v. *Malley*, 249 U.S. 223 (1919), and *Hecht* v. *Malley*, 265 U.S. 144 (1924). In the first of these three cases (*Crocker* v. *Malley*), the Court held that a trust cannot be considered an "association" if the trust's beneficiaries "have no joint action or interest and no control over the fund." 249 U.S. at 234. In *Morrissey*, however, the Court concluded that the so-called "control" requirement of *Crocker* should not be determinative. 296 U.S. at 355 (upholding Treasury Regulations[4] providing that "the extent or lack of control by the beneficiaries of a trust should not *in itself* determine whether there was an association" (emphasis added)). The Court did not, however, hold that the presence or absence of control by the beneficiaries over the trust was irrelevant; the Court merely held that it was not independently "decisive" (*ibid.*).

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the benefit of some other route he might have chosen to follow but did not"); *Higgins* v. *Smith*, 308 U.S. 473, 477 (1940) ("A taxpayer is free to adopt such organization for his affairs as he may choose and having elected to do some business as a corporation, he must accept the tax disadvantages."); *Halstead* v. *Commissioner*, 296 F.2d 61, 62 (2d Cir. 1961) ("Since the taxpayer represented to the taxing authorities that the form of business he set up was an actual partnership, he may not now disclaim its validity.").

[4] See *Morrissey* v. *Commissioner*, 296 U.S. at 354 n. 10 (quoting Regulations 65, Art. 1504 (1924 Revenue Act), as amended). The Court noted that "[a]s the statute merely provided that the term 'corporation' should include 'associations,' without further definition, the Treasury Department was authorized to supply rules for the enforcement of the Act within the permissible bounds of administrative construction." 296 U.S. at 354-355.

The Tax Court expressly acknowledged in this case that the absence of control by the beneficiaries was not dispositive (Pet. App. 77 (citing *Morrisey* v. *Commissioner*, 296 U.S. at 356)). Contrary to petitioners' assertion (Pet. 18, 20, 23), the court thus did not consider the absence of control by Mrs. Whitehouse over WRC to be decisive. Instead, based on consideration of *all* of the relevant criteria—including, but not limited to, the fact that Mrs. Whitehouse did not participate in the affairs of the trust (see *Bedell Trust* v. *Commissioner*, 86 T.C. at 1220-1221)—the Tax Court concluded that Mrs. Whitehouse was not an "associate" of the trust and that the trust therefore was not an "association" (Pet. App. 79-83).[5] The decision in this case thus does not conflict with this Court's decision in *Morrissey*.[6]

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[5] In considering whether the beneficiary participated in the trust's activities, the Tax Court noted, among other things, Mrs. Whitehouse's testimony that she had no role in the business decisions of the trust (Pet. App. 81-82). That inquiry does not constitute the revival of a dispositive "control" requirement of the type precluded by *Morrissey*.

[6] The Tax Court's decision is also consistent with 26 C.F.R. 301.7701-4(a), which provides that "[g]enerally speaking, an arrangement will be treated as a trust under the Internal Revenue Code if it can be shown that the purpose of the arrangement is to vest in trustees responsibility for the protection and conservation of property for beneficiaries who cannot share in the discharge of this responsibility and, therefore, are not associates in a joint enterprise for the conduct of business for profit." Mrs. Whitehouse had no responsibilities with respect to WRC's property (Pet. App. 81).

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

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